KEYNOTE INTERVIEW

Readying for a step change in ESG data

As regulatory regimes tighten, managers need to think carefully about their ESG strategies and how technology and data can help, say IHS Markit's Kevin Bourne and Rishi Kotecha

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Q What ESG-related trends and regulatory developments are on the agenda for 2021?

Kevin Bourne: Regulations are only going in one direction with regards to ESG and climate change. The regulatory regime is going to become much tighter globally as we see a coming together of regulatory standards. We already have China and Europe looking at a joint assessment of the European disclosure regime because China is seeking to align its new regulations with what Europe is doing as the pacesetter. The new Sustainable Finance Disclosure Regulation that comes into force in Europe in March will bring some challenges and is certainly front of mind.

Rishi Kotecha: SFDR will be a gamechanger for the private markets, with its requirements to go into the data and report across the whole investment management process. The regulation will mean there is no hiding place and will act as a true catalyst as the industry continues to drive forward its ESG practices. As we witness increasing investor pressures as sustainability gains greater prominence in the allocation of investor capital, GPs will have to know their data.

Q How do these themes affect demands for data?

KB: The demand for data is a reflection of where ESG has come from, which is a need for increased reporting by public companies, many of whom still have limited or no information in the public domain.

More and more GPs are evaluating ESG considerations as part of due diligence, and the close reporting relationship with investors means the private equity community is keen to

make progress on this. Really, effective ESG is about data discipline, and historically the private equity industry is good at that. We may get to a point where there is more ESG data available about large private companies than there is for smaller and mid-sized public companies, just because private equity firms will support their portfolios with this.

RK: The demand for data is increasing and the impact intensifies as there tends to be a lack of in-house expertise. Historically, having an ESG element to the portfolio would fall under the risk team, but now firms need subject matter experts.

The value of ESG spans across all areas and is not just driven by regulation; some of the demand is coming from a shift in consumer habits, employee expectations, and the way in which companies are operating and futureproofing. In private markets, there is also the value creation angle, where non-financial indicators are becoming more important when thinking about long-term sustainability.

There is no data harmonisation in this area, and no standard set of key performance indicators. There needs to be progress on that to enable benchmarking and so different reporting standard setters can agree on equivalence. However, there is a larger focus on data-driven decision making across private markets, as investors seek a 360-degree view on their portfolios, and with that transparency will come more sophistication on ESG insights.

Q How do the ESG-related pressures facing managers impact risks and returns?

RK: ESG is having an impact across the investment lifecycle, including key fundamental areas of capital allocation, due diligence, data management and risk. It also can impact reputational risk. Surveys conducted across the LP community show how focused they are on future-proofing their portfolios and looking for sustainability.

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>
> **KEVIN BOURNE**

From a risk perspective, one thing we continually hear is GPs opining that they have always had good practice around ESG, since a fundamental part of success is to have the core operating practices in place, but it just was not called out as such. That is up for debate – what we do need to ensure now is strong alignment and measurement between investment processes and ESG practices to support long-term value creation.

Demonstrating good ESG is also important for exit strategies, especially if a private equity firm is looking at an IPO there is real value in being able to demonstrate strong ESG practices during those processes.

KB: I cannot imagine why any company would go public today without an ESG report that covers all the basic facets, making it a transparent element of the company's message. Any CEO should understand the operational footprint of ESG credentials, as ESG data is becoming an absolute must-have.

The tenor for this was set back in 2015 with the Montreal Pledge, when asset owners said they wanted to understand the emissions footprints of the companies they were invested in and asked GPs to calculate them. Many fund managers said no, but those that said no did not get the same level of engagement from investors and so were forced to change their approach.

The market has moved on since then and there is much more understanding that investors want this information, and it does have risk and return implications. Any private equity or venture firm that does not understand ESG in its portfolio is at risk and any public fund manager that does not understand ESG is at risk, because they are out of step with investors, with regulators, and with the reality of the capital markets. If you cannot have a dialogue about how your portfolio takes these issues into account, investors will increasingly question your processes. Understanding ESG as a commercial risk for all managers is now critical.

Q How can managers get ahead of the market when it comes to responsible investment?

RK: First, if managers are not following guidelines today, they need to do so. They need to take stock and focus on and understand the KPIs that need to be collected, and the regulation is going to be a good driver for that.

There has been an accelerated focus on preparedness and disaster recovery in light of covid-19, with managers making sure they know how their

Q Is there a role for technology in addressing ESG challenges?

RK: There is an increasing demand for data and an increasing need for digitisation to drive a step change in this area. ESG is driving a focus on data and insights because what gets measured gets managed, and technology is a critical component to quantifying that ESG data and optimising its value.

We are seeing increasing maturity and professionalism in ESG practices, but there is still a disparity in the data being collected.

This is no longer a box-ticking exercise for GPs, with LPs demanding the ability to look at ESG metrics across their portfolios and dashboards to understand companies better, particularly with the advent of SFDR. Technology will be the enabler to take all that forward and it will play a pivotal role as it helps avoid duplication and inconsistencies and allows private equity firms to look across their portfolios and focus on the right levers. We have seen the significant role that technology already plays for private equity firms, GPs and LPs when it comes to monitoring the financials of their portfolio and benchmarking; all in turn leading to data management efficiencies and better decision support efforts. The ESG paradigm is another extension of that and making sure that the technology is relevant, robust and scalable is critical.

KB: One of the big challenges is not just having the technology to analyse the data but knowing what funds are seeking to do with the data. We are regularly asked to help private equity funds build and develop their ESG frameworks, with some starting from ground zero and others with frameworks in place that need third-party review. Managers have got to create frameworks, get them down to companies and develop workflows that will make the right information available.

It is easy to build a system that collects the data, but not so easy to build a system that uses the data to solve the business problem and enables measurement and reporting. Managers need to think about how they are going to share scores with investors, which requires first-class ESG data as well as first-class systems. A lot of private equity managers, including some of the biggest players, are finding they still have a long way to go and need to get there faster.

portfolios will be impacted. Managers need to start with a series of high-level KPIs, because the direction of travel is only going one way and that is towards greater transparency on non-financials and how those impact portfolio performance.

Best practice will evolve, and we will hopefully see more data harmonisation as the regulation pushes a drive for standard taxonomies. GPs are facing a growing number of requests and firms like ourselves continue to focus on our asset manager clients and how we can bring more simplification around a common data set.

KB: If a private equity firm asked me how best to approach this, I would suggest tackling it in layers. If the firm tries to do everything at once, it may not succeed. Managers need to focus first on getting the foundations right, which is about technology and process, and getting the data right, which is about how they engage with their portfolio and assemble that data. Then it is about communicating that information to investors.

The next step is using ESG not as a reaction to the market but as something firms can lead with, demonstrating it is not just something they do but a reason to invest with them. It is a business attribute rather than just a regulatory response.

My advice is: do not try and collect too much information from your portfolio and instead be realistic about what data points you are trying to collect. Make sure you are consistent across these data points so that you can drive comparison. In this way, and by tackling it in layers, you will be able to get to the point where ESG is an attribute much sooner. ■

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